

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:NER:BRK:TL-N-2246-00

TKerrigan

date:

to: Chief, Examination Branch IV  
Attention: Manager Group 1047 - Income  
E:E:F:1047

from: District Counsel  
Brooklyn CC:NER:BRK

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subject: [REDACTED] - Legal Settlement

EIN: [REDACTED]  
Taxable year [REDACTED]  
U.I.L. No. 0162.25-08

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This memorandum is in response to your request for advice, dated April 6, 2000, concerning the Federal income tax consequences under I.R.C. § 162 of amounts paid by the taxpayer pursuant to the settlement of a civil lawsuit.

**FACTS**

The relevant facts, as we understand them, are as follows: The taxpayer, a subchapter S Corporation with [REDACTED] shareholders, is an insurance broker. In [REDACTED], [REDACTED] and its subsidiaries commenced a civil action in the [REDACTED] against the taxpayer and its shareholders for their alleged role in the submission of fraudulent insurance claims under policies written by [REDACTED] between [REDACTED] and [REDACTED]. On [REDACTED], the parties entered into a settlement agreement with respect to the litigation whereby the taxpayer agreed to pay the sum of \$[REDACTED] plus interest in full satisfaction of all claims against

all defendants for the alleged violations set forth in the complaint. Upon execution of the settlement agreement, the taxpayer tendered a payment in the amount of \$[REDACTED] to [REDACTED].<sup>1/</sup> On its [REDACTED] Form 1120S, U.S. Individual Income Tax Return for an S Corporation, the taxpayer claimed a deduction in the amount of \$[REDACTED] for the payment made to [REDACTED] pursuant to the settlement agreement.

### ISSUE

Whether, under the facts set forth above, the payment made by the taxpayer for purposes of settling a civil lawsuit is deductible as an ordinary and necessary business expenses pursuant to I.R.C. § 162(a).

### LEGAL ANALYSIS

I.R.C. § 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg. 1.162-1(a) provides that deductible expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. To qualify as a deduction under I.R.C. § 162, an expense must satisfy a five part test. It must be (1) paid or incurred during the taxable year, (2) for carrying on a trade or business, (3) an expense, (4) necessary, and (5) ordinary. Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 352 (1971).

Generally, payments in settlement of a suit arising from allegedly fraudulent activities are deductible as ordinary and necessary business expenses where the acts, which gave rise to the litigation, were performed in the ordinary course of the taxpayer's business. See Federation Bank and Trust Co. v. Commissioner, 27 T.C. 960 (1957), aff'd, 256 F.2d 764 (2d Cir. 1958) [Deduction allowed for amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets]; Ostrom v. Commissioner, 77 T.C. 608 (1981) [Payments made in settlement of a damage award arising from fraudulent statements about the financial condition of the company made to an investor were deductible as ordinary and necessary business expense]; Milner Enterprises Inc. v. Commissioner, 65-2 USTC ¶ 9612 [Payment in settlement of suit for compensatory damages brought by United States for the alleged fraudulent sale of surplus motor vehicles was a business

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<sup>1/</sup> The parties agreed that the remaining balance of the settlement amount would be paid out of any funds due the taxpayer under profit sharing fund arrangements with [REDACTED].

expense]; Caldwell v. Commissioner, 234 F.2d 660 (6th Cir. 1956) rev'g and remanding 24 T.C. 597 (1955) [Amount paid in settlement of a judgment rendered against a corporation for fraud was deductible as an ordinary and necessary business expense]; Helvering v. Hampton, 79 F.2d 358 (9th Cir. 1935), aff'g B.T.A. Memo. Dec. 7697-C [Payment in settlement of a judgment based in part on fraudulent activities in connection with real estate activities were deductible]; See also Rev. Rul. 80-211, 1980-2 C.B. 57 [Deduction allowed to a corporation for amounts paid as punitive damages that arose from a civil lawsuit against the corporation for breach of contract and fraud in connection with the ordinary course of its business activities]; Rev. Rul. 79-208, 1979-2 C.B. 79 [Deduction allowed for payments to settle lawsuit and obtain a release from claims under a franchise agreement].

Payments to settle a claim against a corporation in a lawsuit have been held to be ordinary and necessary business expenses so long as the payments were a reasonable way of protecting the corporation or mitigating potential damages. Old Town Corp. v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5. The origin of the claim test is the appropriate method of determining whether a settlement payment is a capital expenditure or business expense. In United States v. Gilmore, 372 U.S. 39, 49 (1962), the Supreme Court held that a determination whether costs of litigation were deductible business expenses is determined by considering the "origin and character of the claim with respect to which an expense was incurred". In Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971), the court concluded that the examination of the origin and character of the claim with respect to which a settlement is made is the controlling test in determining whether a settlement payment constitutes a deductible business expense or a nondeductible capital outlay. Rev. Rul. 80-119, 1980-1 C.B. 41, provides further guidance with respect to the application of this test. In that revenue ruling, the Service applied the origin of the claim test to each settled claim to determine whether the settlement payment was a deductible business expense, a nondeductible capital outlay or a combination of the two types of expenditures. This determination was made by examining each claim to discover if it originated in the course of the conduct of a trade or business or if it originated in a transaction giving rise to a nondeductible expenditure.<sup>2/</sup>

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<sup>2/</sup> Since each of the settled claims originated in a stock purchase transaction (i.e. the acquisition of a capital asset) the ruling holds that the entire amount of the settlement payment is a capital expenditure.

In the instant case, the settlement of the pending civil action originates in a dispute as to the taxpayer's role in the submission of fraudulent insurance claims to the insurer. The alleged misconduct was not related to the acquisition of a capital asset, but rather, arose from the business activities of taxpayer in its capacity as an insurance broker. Under the origin of claim test, the claim against the taxpayer has its origin in the conduct of the taxpayer's business. Accordingly, the settlement payment was a business expenses and not a capital expenditure.<sup>3/</sup>

### CONCLUSION

Based on the above facts and circumstances, the settlement amount was paid by the taxpayer in the ordinary course of its business operations, satisfies the five requirements set forth in Lincoln Savings & Loan Association above, and is deductible as an ordinary and necessary business expense under I.R.C. § 162.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

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JODY TANCER  
Acting District Counsel

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<sup>3/</sup> In the advice request memorandum, dated April 6, 2000, the revenue agent suggests that Treas. Reg. § 1.162-21 may provide a basis for disallowing the deduction. We note that I.R.C. § 162(f) provides that no deduction is allowed for any fine or similar penalty paid for any violation of law. In order for I.R.C. § 162(f) and Treas. Reg. § 162-21 to apply, however, the payment must be made to a "government" and the payment must constitute a "fine or similar penalty". The settlement payment at issue does not meet the statutory requirement.